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Introduction

Accounting, perhaps more than any other business discipline, is governed by "conventions," that is, generally accepted ways of doing things. One of the most fundamental accounting conventions is the cost principle, which states: "Cost (i.e., the resources given up in the acquisition of other goods and services) is the appropriate basis for initial recording and subsequent accounting for assets, liabilities, revenues and expenses."[1]

The significance of this cost principle is that the monetary amount at which a transaction or event is initially recorded in a company's accounts becomes the reported value of that transaction or event as long as it remains in the company's records, regardless of changes that may take place in the purchasing power of the monetary unit over time. In periods when the monetary unit is relatively stable, the cost principle works quite well in corporate financial reporting, because historical cost has some very reassuring qualities. It is, for example, a hard fact that is easily verifiable. But the monetary units of most nations have been anything but stable in the economic conditions prevailing in recent years. Even in the United States, long considered a bastion of currency stability, double-digit rates of inflation have been experienced.

The reality of inflation has had a wrenching effect on the thinking of both the producers (accountants) and consumers (investors) of financial information. On the one hand, there is the disquieting realization that, as inflation continues, financial reports based on the convention of historical costs are becoming less and less meaningful for economic decision making. On the other hand, there is a strong reluctance to abandon the firm base of historical cost because of the justifiable fear that such a departure would undermine the credibility of accounting and would further aggravate the difficulty that many people already experience in trying to understand financial statements.

The accounting rule-making agencies in the United States have wrestled for many years with the problem of inflation in accounting and the subject has been a source of continuing debate, study and experimentation ever since the end of World War II. Finally, in 1976, the Securities and Exchange Commission grasped the bull by the horns and decreed that some large corporations had to inform readers of their financial reports of certain of the effects of inflation. The SEC's ruling met with much adverse criticism by preparers and did not generate much enthusiasm from the public.

Three years later, in the Fall of 1979, the Financial Accounting Standards Board, the rule-making agency of the private sector, released its Statement No. 33, "Financial Reporting and Changing Prices," commonly referred to as "FAS 33."[2] Actually, FAS 33 applies only to a relatively small number of large corporations: Only those firms with assets totaling more than $1 billion, or whose inventories and property, plant and equipment (before deducting accumulated depreciation) amount to more than $125 million are required to comply. These size limitations are somewhat comparable to the SEC's 1976 requirement, which was withdrawn when FAS 33 went into full effect.

FAS 33 represented a significant departure from earlier official thinking in accounting because, for the first time, it permitted a departure from the historical cost principle in corporate financial reporting. The FASB decreed that certain inflation-adjusted data entering into the computation of net income had to be presented as *supplemental* disclosures in the annual stockholders' reports of the affected corporations. Furthermore, the FASB required the inflation-adjusted data to be prepared on two bases: constant dollars and current costs.[3] (See box on p. 5.)

An important provision of FAS 33 is that the primary

[1]Glenn A. Welsch and Robert N. Anthony, *Fundamentals of Financial Accounting*, 3rd ed., Homewood, Illinois: Richard D. Irwin, Inc., 1981, p. 68.

[2]Statement of Financial Accounting Standards No. 33, "Financial Reporting and Changing Prices," September 1979. Copyright © Financial Accounting Standards Board of the Financial Accounting Foundation, High Ridge Park, Stamford, Connecticut 06905.

[3]For a more complete description of the requirements of FAS 33 and of the long series of events leading up to its release, see Francis J. Walsh, Jr., *Recognizing Inflation in Accounting*. Conference Board Report No. 783, 1980.

financial statements would continue to be prepared on the basis of conventional, historical costs. Thus, readers of annual reports would see disclosures of net income on three different bases of cost determination: historical costs, constant dollars, and current costs.

The Financial Accounting Standards Board further declared that FAS 33 was to be considered an experiment. Therefore, it encouraged preparers of financial statements to try different methods of computation and disclosure in order to develop the most effective presentations. The FASB promised to monitor progress with the FAS 33 experiment and to assist preparers in dealing with problems arising in practice. This it has done. And it has also invited the accounting profession, academic researchers, and the business community to conduct research into the effectiveness of FAS 33 and to develop recommendations for improving it.

This report is an attempt to gauge the reactions of a cross section of senior financial executives of large corporations, who have had some experience with the preparation and presentation of FAS 33 data. The Conference Board hopes that the insights gained from these executives will be helpful to the FASB in monitoring its experiment. Furthermore, it hopes that other executives will be encouraged to follow the lead of the survey participants by expressing their views and experiences either to other researchers or directly to the FASB.

This report is not intended to be a census of the attitudes of the entire business community toward inflation accounting. Rather, it was designed to obtain the reactions of a limited number of financial executives in a variety of industries whose firms are of sufficient size to come within the purview of FAS 33. While it is inevitable that many of those to whom the survey was directed are very large corporations, the sampling was designed to include a great many smaller companies at the lower end of the compliance spectrum. The Conference Board is grateful to the financial executives of the 90 companies responding to the questionnaire.

Perceived Reactions of Investors

The experience of the 90 companies participating in this survey indicates that FAS 33 data have had a rather slight influence so far on these companies' relationships with stockholders and other investors. The survey sought to discover not only whether companies have had any feedback from their stockholders about their inflation disclosures, but also whether professional security analysts have shown any interest.

Assessments of Stockholder Attitudes

Only eight of the ninety participating companies report that they have made any attempt to learn the attitudes of their stockholders and other investors toward the inflation disclosures in their annual reports. And most of the eight companies admit that these reactions have been rather negative.

One respondent bluntly characterizes the inflation disclosures as a waste of time and money because investors do not understand the data. This is an extreme view, however. A different reaction is reported by a respondent whose parent company is headquartered in the United Kingdom and is, therefore, subject to the current-cost conventions of the British accounting profession. The company's controller states that the investment community in London appears to have a favorable attitude toward inflation-adjusted financial reports. And he emphasizes that these presentations appear as the *primary* financial statements, rather than as the supplementary disclosures mandated in this country by FAS 33.

The overwhelming majority of responding companies have limited their presentations of inflation-adjusted data to that which is mandated by FAS 33. Only six companies have gone beyond the disclosures required in their annual reports. These few companies state that they have also given information about the effects of inflation in annual meeting presentations and post-meeting reports, quarterly reports to stockholders, and data supplied to financial analysts. One participant states that all of his company's external financial communications contain information about inflation.

Analysts' Inquiries

As the most sophisticated consumers of corporate financial information, professional security analysts might be expected to delve more deeply into corporate disclosures of inflationary effects than the average shareholder. The experience of the 90 survey participants, however, contradicts this expectation. Eighty-two of the respondents report that analysts do not ask for any additional inflation information beyond what is presented in compliance with FAS 33. And two financial executives added the comment that the analysts do not ask any questions about the FAS 33 data either.

The inflation-related items that they have asked about in the eight companies reporting such inquiries include:

- Effects of inflation on LIFO (last in, first out) inventory values;
- Effects on selling prices;
- Effects on raw materials costs;
- Effects on energy costs;

• Adjusted valuations of inventories, property, plant and equipment, and natural resources.

None of the survey respondents believes that the disclosures required by FAS 33 have had any effects on the company's ability to raise capital.

Perceived Reactions of Boards of Directors

FAS 33 disclosures have had a slightly more noticeable effect on boards of directors than they have had on external readers of financial reports, such as stockholders and security analysts, according to the surveyed financial executives. Even so, the great majority of participants report that many directors seem to be rather indifferent toward inflation-adjusted financial information.

Data Furnished to Directors

Boards of directors, of course, receive the same FAS 33 data each year that are included in annual reports to stockholders. But 23 of the participating companies provide a variety of additional information to their boards concerning inflation. Following are the kinds of information furnished:

• Planning data adjusted for anticipated inflation, including forecasts, long-range planning information, and budgets;
• Capital expenditure proposals adjusted for inflation;
• Comparison of FAS 33 data with those reported by competitors;
• Sales and other operating data adjusted for inflation, including division and subsidiary information;
• Quarterly financial reports containing FAS 33 adjustments;
• Restatement of income statements for the past five years.

Only eight of the survey respondents indicate that their boards of directors have asked for inflation-related information beyond that which is routinely supplied by company managements. The areas of concern expressed by these directors most frequently included sales, inventories and divisional performance.

Dividend Policies

Only five of the responding financial executives feel that FAS 33 information has had any effects on their companies' dividend policies. Those commenting on this question state that their boards of directors had considered the effects of inflation in their deliberations on dividend payments, and in the general management of

The Current-Cost and Constant-Dollar Methods of Calculating Inflation Adjustments

Current-Cost Accounting

FASB Statement No. 33 defines current-cost accounting as: "A method of measuring and reporting assets and expenses associated with the use or sale of assets, at their current cost or lower recoverable amount at the balance sheet date or at the date of use or sale."

Current-cost accounting, unlike constant-dollar accounting, makes no attempt to retain its tie to historical dollars. The philosophy of current-cost accounting, declares, in effect, that the dollars expended at some point in the past have no relevance in the preparation of a present-day financial statement during an inflationary period. According to this view, the only relevant numbers are the dollars that would be expended if an asset were to be acquired on the balance sheet date. Proponents of this view believe that any other method of valuation is not economically realistic during inflation.

Furthermore, current-cost accounting regards the effects of inflation on an enterprise not in terms of changes in the general price level, as in the case of constant-dollar accounting. Rather, it concentrates on the price-level changes of the specific commodities or assets with which the individual firm is concerned.

The current-cost technique requires the selection of appropriate methods of determining current costs of the items to be measured. FASB Statement No. 33 suggests internally or externally generated price indexes for the class of goods or services being measured; references to current invoice prices; vendors' price lists or other quotations or estimates; and standard manufacturing costs that reflect current costs.

Constant-Dollar Accounting

FASB Statement No. 33 defines constant-dollar accounting as: "A method of reporting financial statement elements in dollars each of which has the same (i.e., constant) general purchasing power. This method of accounting is often described as accounting in units of general purchasing power or as accounting in units of current purchasing power."

The important element in this definition for the purposes of this discussion is the concept of reporting in dollars of the same general purchasing power. Constant-dollar accounting differs fundamentally from the current-cost accounting approach in this emphasis on changes in general purchasing power, rather than on changes in prices of specific commodities or groups of commodities.

retained earnings, long before FAS 33 data were available.

One executive adds, however, that the revelations of the FAS 33 computations served to reinforce his board's already restrained policy of dividend payouts. Another participant observes that his company's goals for the 1980's have been reconstituted in the light of inflationary conditions, and an important consideration is the effect of rising prices on the growth of dividends.

Only two executives believe that FAS 33 data have had any effects on the debt-equity mix in their corporate capital structures. One of these respondents feels that these disclosures have reduced borrowing capacity. The other believes that the disclosures have served to highlight the effects of inflation with a consequent influence on financing decisions. This participant adds that it is the reality of inflation, rather than the mere financial reporting of its effects, that really influences debt-equity decisions.

Reactions of Management

The 90 financial executives taking part in this survey went to considerable lengths to explain their own experiences with, and reactions to, FAS 33 disclosures. For the most part, they are able to do this from two points of view: first, as the corporate officers who are principally responsible for preparing their firms' periodic financial reports, with their accompanying FAS 33 disclosures; and, second, as informed consumers of financial statement information.

The principal points on which these executives were polled were:

- The areas of difficulty that they encountered, as preparers of financial statements, in complying with FAS 33 requirements;
- Their assessment of the parts of FAS 33 that need to be changed or improved;
- The extent to which inflation-adjusted data are used in their companies for internal management reporting purposes;
- Their attitudes toward increased disclosure of inflation-adjusted data to investors, specifically in interim or quarterly reports;
- Their overall assessment of the value of presenting inflation-adjusted information to investors.

Areas of Difficulty

Many of the accounting standards introduced during the past two decades have caused varying degrees of difficulty for the preparers of corporate financial statements. FAS 33 would have to rate among those that are inherently troublesome. As one example, many companies had to delve far back in their accounting records to unearth acquisition dates and costs for items that needed to be restated in terms of both constant dollars and current costs. Just the sheer volume of such work in large companies—even with the aid of computers—is a difficulty to be reckoned with.

Principal Areas of Difficulty in Complying with Requirements of FAS 33

Problems related to the current-cost method:	Number of Mentions
Computing values of natural resources and of plants, property and equipment, and related depreciation	49
Computing current-cost valuations for foreign subsidiaries	8
Developing indexes and methodology	7
Computing values of inventories and cost of goods sold	5
Problems related to the constant-dollar method:	
General objections to this method	3
Computing values of plants, property and equipment and related depreciation	2
Cost-of-goods-sold adjustments	2
General objection:	
Compliance with the standard is too costly and time-consuming	6

Only eight out of the ninety respondents report that they do not consider FAS 33 particularly difficult to comply with. Some of these companies are in industries where fixed assets and depreciation are less of a factor than in other lines of business. Two others state that the standard presents no insurmountable conceptual problems, but they nevertheless complain of the time-consuming features. All of the other survey participants declare that they found at least some of the requirements difficult to comply with.

As summarized in the accompanying box, reported difficulties in complying with FAS 33 because of the current-cost method outnumber those related to the constant-dollar method by almost ten-to-one. Within this broad category, the principal problems have to do with computing the values and related depreciation of natural resources and of plants, property and equipment. Forty-nine respondents point to this difficulty as their principal problem with the standard. For example, the vice

president and controller of a communications equipment company states: "Determination of current-cost data for property, plant and equipment was costly and time-consuming, primarily because of decentralized record keeping, diversified nature of businesses, foreign operations, and highly subjective nature of the underlying assumptions."

Because only large corporations are presently required to comply with FAS 33, it is inevitable that many of them have substantial foreign operations. This complication adds further difficulties in the attempt to report on the current-cost basis. As the representative of an office equipment company puts it:

"Internal manufacturing cycles make the determination of representative current costs difficult in a multiproduct environment. In addition, there is the problem of instructing, preparing and consolidating information from over 100 countries."

The current-cost method presents a major problem for the preparers of financial statements in that a method must be devised in each company for estimating the current costs of the items to be measured. FAS 33 points out various ways of accomplishing this task, for example, references to current invoice prices, vendors' price lists, or other quotations or estimates. When these are not available, the standard suggests the development of custom-tailored price indexes. A good many companies have chosen this alternative but it has proven to be costly. As the vice president of a metals company observes:

"Many man-hours were spent attempting to determine the approach that would provide the most meaningful and reliable information. We ultimately decided to develop an internal index, which again required large amounts of time."

Summing up the problems encountered with the current-cost method, an executive of an oil field equipment company concludes:

"Current-cost information was most difficult, although it is more meaningful than constant-dollar information. There is, therefore, a trade-off between relevance and effort."

As the box shows, only seven responding executives complain of difficulties with the constant-dollar approach to estimating the effects of inflation. Comments indicate that their objection is directed at the conceptual foundation of this method: that the historical cost values of all items to be restated respond equally to changes in the general price level. Critics of the constant-dollar approach say that this assumption is unrealistic. One executive also takes exception to the FAS 33 requirement that the Consumer Price Index be used to make constant-dollar adjustments. As he sees it: "The CPI has the advantage of being updated frequently, but it has very little to do with the movements of prices in our lines of business."

Shortcomings in FAS 33 Most Frequently Reported by Responding Executives

	Number of Mentions
Inappropriateness of the Consumer Price Index	9
Lack of recognition of technological advances in production facilities; also, facilities are seldom replaced "in kind"	8
No restatement of income tax expense is permitted	8
Insufficient recognition of holding, or purchasing power, gains and losses	7
Partial, rather than complete, adjustment of financial statement items	5
Ignores variations among different industries	3
Effects of inflation on cash flow are not clearly disclosed	3
No recognition is given to the anti-inflation measures adopted by management (e.g., in product pricing and improvements in efficiency)	3
Miscellaneous	11

Other difficulties mentioned by a few survey participants are:

- Educating the accounting staff to do the required computations;
- Explaining the data to readers of financial reports, especially in light of the rather confusing terminology employed;
- Computing holding gains.

Portions of the Standard that Need Improvement

Above and beyond the difficulties they encountered in complying with FAS 33, 57 of the 90 participating financial executives point to what they consider to be shortcomings in the standard as it is presently constituted. A variety of such comments were offered and those most frequently cited are summarized in the accompanying box.

A requirement of the constant-dollar method, one of the two approaches to computing inflation adjustments mandated by FAS 33, is to revalue certain financial statement items in terms of the Consumer Price Index

(CPI) for all urban consumers, published by the Bureau of Labor Statistics of the U.S. Department of Labor. The designation of this index is criticized by one in ten of the executives taking part in the survey. A number of respondents object to the constant-dollar method as a whole because they believe it is unrealistic to assume that the prices of all commodities move up or down at the same rate—the underlying postulate of the constant-dollar method. But, leaving this general objection aside, some feel that a consumer price index is by definition unsuitable as a measure of inflation for their businesses and that it distorts the results of attempts to quantify the effects of inflation on their companies.

Another frequently voiced criticism is that the inflation-adjusted balances of fixed asset items under the current-cost method often do not give adequate recognition to technological changes and improvements. Several executives make the point that facilities being phased out are seldom replaced in kind. To assume that they are, they say, distorts the recomputation of depreciation expense and net income for their companies.

Income tax expense is an important element in the determination of net income. And FAS 33 requires that this expense be set forth in the schedule, Statement of Net Income From Continuing Operations Adjusted for Changing Prices, under all three bases of reporting (historical costs, constant dollars, and current costs). Because inflation adjustments have not been recognized by the Internal Revenue Service in determining tax bills, the provision for income taxes is reported as the same amount under all three bases. Some executives object to this treatment on the grounds that the inflation-adjusted statements are only supplementary disclosures anyway, and a truer picture of the effects of inflation might be obtained if tax liabilities were restated in line with the restated net incomes.

Seven financial executives also are critical of the way they are required to report the purchasing power gain or loss on net monetary items. Several suggest that this is an important element of information that deserves greater recognition than FAS 33 accords it. And another five participants object to FAS 33's approach of applying inflation adjustments to only a few critical elements of financial statements. This group believes that restatement of all items is desirable.

A few other executives point out that FAS 33 cannot reflect variations among different industries in terms of the different effects of inflation on them; also, the effects of inflation on cash flow are not clearly set forth. And no recognition is given to the anti-inflation measures adopted by management.

A number of other shortcomings of FAS 33, reported by a few of the surveyed executives, include the following:

- Concurrent restatement under two approaches (constant dollar and current cost) is confusing and time consuming;
- The current-cost method overstates the effects of inflation on net income;
- The standard is too broad in scope and too much information is buried;
- Approach adopted by the accounting profession in the United Kingdom should be considered in the United States;
- Effects of inflation on long-term procurement contracts should be disclosed;
- Effects of inflation on foreign operations are not disclosed;
- The current-cost method involves too much subjective judgment;
- Interest costs are not adequately treated;
- The disclosures should distinguish between effects of inflation on operating decisions as against those affecting financing decisions.

Internal Uses of Inflation-Adjusted Data

The disclosure provisions of FAS 33 apply only to the annual stockholders' reports of a limited number of large, listed corporations. Nevertheless, a few firms have gone a step beyond this minimum requirement and have begun to use inflation-adjusted data for internal management reporting purposes.[4]

Only twenty-five of the ninety executives taking part in this survey report that their firms use such information internally. The types of internal applications listed by these executives follow:

Type of Application	Number of Mentions
Income statement and balance sheet information, including ratios, by segments, product lines, or divisions	12
Capital expenditure proposals	7
Long-range forecasts and plans	5
Pricing proposals and decisions	3
Inventory information	3
Annual budget information	2
Adoption of LIFO	2
Sales analysis	2
Quarterly income statement and balance sheets for the company as a whole	2
Analysis of acquisition candidates; and analysis of competitors	1 each

Two respondents emphasize that they use only current-cost data in their internal applications. Another states that his firm's decision to supply inflation-adjusted data

[4]See, for example: Allen H. Seed, III, *The Impact of Inflation on Internal Planning and Control.* New York: National Association of Accountants, 1981; Francis J. Walsh, Jr., *Reporting Information to Management Under Conditions of Inflation: Report on a Forum.* Conference Board, RB No. 104, 1981.

internally was not really influenced by FAS 33; they were doing it anyway.

Internal uses of inflation information are presently in a highly evolutionary state. And although such usage is rather limited so far, there are a number of companies in various stages of developing this information. The following statement by the chief financial officer of a building products company is an example:

"Many of the company's divisions are already using various techniques designed to measure and report the effects of inflation. In addition, we have recently organized a task force, comprised of representatives of various functional areas within the company, that has been charged with the responsibility for identifying those measurement and reporting techniques that will be most useful on a company wide basis in helping managers at all levels in dealing with inflation. The specific method by which inflation-adjusted financial data will be incorporated in the company's internal management information and reporting system will be contingent on the findings of the task force."

Attitudes Toward Increased Public Disclosure

The executives responding to the Board's inquiry are overwhelmingly opposed to the idea of extending inflation disclosures to interim or quarterly reports to stockholders and to the general public. Only four out of ninety see any merit in this. Their objections can be summarized very briefly as follows:

- The cost of presenting inflation-adjusted data on an interim basis would far exceed any benefits;
- Such information is meaningless for short time periods;
- The annual disclosures are confusing to many stockholders, and interim information would only make the situation worse;
- Few investors have shown any interest in inflation information, even on an annual basis.

Two of the four executives favoring interim disclosures do so on the ground that historical cost information has become meaningless.

Overall Assessment

Despite difficulties encountered in complying with its provisions, and their criticisms of its shortcomings, a majority of the 90 executives participating in this survey believe that the FAS 33 experiment is worthwhile. And they support the Financial Accounting Standards Board's efforts to bring the effects of inflation to the attention of the general public.

The responses to the question: "Based on your experience with FAS 33 so far, do you believe it is worthwhile to present inflation-adjusted financial information to investors?" are shown below:

	Number	Percent of Total
Yes	42	47%
No	29	32
Undecided	19	21
Totals	90	100%

The executives offered a variety of reasons in support of their opinions. Those who believe the FAS 33 effort is worthwhile most often cite the need to increase the awareness of the investing public and of government officials to the "real" levels of taxation and dividend payouts. And, in a related vein, they point out that FAS 33 is a step in the educational process of showing what inflation does to capital formation, and of the need to retain earnings to finance future growth. Several participants make the point that these benefits are so important that it is wasteful to argue over which inflation measurement method is to be used—the important thing is to get the message across.

Other reasons in support of the "yes" votes are:

- The data improve comparability among firms;
- The data assess ability to survive or expand;
- Management is in a better position to measure inflationary effects than analysts or individual investors;
- Historical cost data are no longer relevant;
- The adjusted data help bring book values and stock prices more closely into agreement;
- The data assist investors to assess cash flows and other trends.

The nearly one-third of the responding executives who do not believe it is worthwhile to present inflation-adjusted financial information to investors also give a variety of reasons for their position. The principal ones are that the data are too vague, too subjective, and too confusing—and, therefore, are beyond the understanding of most investors. They also point out that, in their experience, there is very little interest in the information on the part of investors, possibly because they have grown accustomed to discounting the effects of inflation when reading conventional financial statements. In sum, the adjusted data have limited value in making investment decisions and the cost of producing the information far outweighs the benefits.

Other reasons given in support of their "no" votes are:

- The CPI index distorts results;
- Inflation accounting cannot solve the basic problem of eliminating inflation from the economy;
- It is impossible to segregate the effects of past inflation because prices often change for reasons other than inflation;

• The FASB should have worked out the problems of inflation accounting, including a meaningful reporting format, before issuing the standard.

Several executives, while supporting the concept of reporting the effects of inflation, believe it would be better if company managements were permitted to choose their own methods for doing so. In particular, these participants think that a shorter presentation than the one that is presently required would be preferable.

Summing up the majority opinion on the overall worth of the FAS 33 experiment, an executive of an electrical products company makes the following observation:

"The FASB is on the right track. Inflation has a significant impact on business. Because it is complicated and difficult to understand is not justification for not trying to explain its effects. The FASB approach of disclosing inflation-adjusted data on an experimental basis is the correct approach. As these disclosures are prepared and made, both preparers and users will begin to develop an understanding of the effects of inflation, and sound accounting and reporting of inflation-adjusted data will evolve."